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In the Supreme Court of the United States

OCTOBER TERM, 1938

No. 98

M. E. BLATT COMPANY, PETITIONER
v.
THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the court below (R. 5-14) is reported in 23 F. Supp. 461.

JURISDICTION

The judgment of the Court of Claims was entered May 31, 1938 (R. 14). The petition for a writ of certiorari was filed June 7, 1938 (R. 14), and was granted October 10, 1938. The jurisdiction of this Court is conferred by Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether the depreciated value of improvements to leased property made by a lessee as required by the lease agreement constituted income to the lessor at the time of their completion.

STATUTE AND OTHER AUTHORITIES INVOLVED

The pertinent portions of the applicable statute and other authorities involved are set forth in the Appendix, *infra*, pp. 22–34.

STATEMENT

Petitioner, a corporation, made and filed a consolidated return of income for the taxable year ended January 31, 1932, for itself and a subsidiary corporation, the Mebco Realty Holding Company (hereinafter referred to as the Realty Company), showing a tax due of $3,920.10, which was paid by petitioner (R. 6).

The Commissioner of Internal Revenue as a result of changes in the reported income of the Realty Company thereafter determined a deficiency in the tax amounting to $1,133.84, which was assessed against the petitioner and was paid by the petitioner September 5, 1934, with interest amounting to $160.41 (R. 6).

Among the changes so made which resulted in the deficiency was the addition to the income of the Realty Company of $1,742.31 as a result of the following transaction (R. 6–7):

On September 13, 1930, the Realty Company leased to the Ventnor Realty & Leasing Company (herein referred to as the Ventnor Company) for use as a moving picture theater certain improved real estate owned by it in Atlantic City. The lease was for a term of ten years beginning upon the day certain improvements were completed by the landlord. With respect to the contemplated improvements the lease provided (R. 7):

> It is further agreed by and between the parties hereto that the landlord will, at its own cost and expense, make and complete alterations to the entrance and theatre, which is to accommodate as many seats as possible, and include plastering but no decorating, in accordance with the plans and specifications to be prepared by an architect to be selected by the parties hereto. It is further agreed that the tenant will paint and decorate, provided the landlord contributes a sum not exceeding Fifteen Hundred Dollars ($1,500) for such purpose to tenant. Tenant agrees to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord.

On October 3, 1930, the Realty Company contracted for the making of alterations and improve-

ments as contemplated by the parties to the lease, the contract providing that the Realty Company would pay the actual cost of the alterations and improvements, provided that the total cost, including contractor's profit and architect's fee, should not exceed $65,000, and that any additional work and materials ordered by the Ventnor Company would be paid for by it (R. 7).

All the alterations and improvements were completed in January 1931, and the Ventnor Company, as lessee, took possession of the property February 1, 1931 (R. 8).

The total cost of all the alterations and improvements was $114,468.77, which was charged to the lessor and lessee, respectively, and paid for by them, as follows (R. 8):

Paid by the Realty Company, lessor:		
Brick, steel, lumber, concrete	$45,068.78	
Heating and plumbing system	7,716.82	
Electrical work	8,699.84	
Ventilation system (partial)	3,514.61	
		$65,000.00
Building changes	661.86	
New store fronts (4)	8,132.61	
		8,794.47
		73,794.47
Paid by the Ventnor Company, lessee:		
Ventilating system (balance)	3,959.75	
Decorating, glazing, and architect's fee	11,313.14	
Chairs	9,167.24	
Booth	5,197.39	
Draperies	7,075.42	
Electric signs and marquee	3,961.36	
		40,674.30
		114,468.77

The estimated depreciated value at the termination of the lease of the alterations and improve-

ments paid for by the lessee was computed by the Commissioner and was agreed to by the petitioner, as follows (R. 8):

	Cost	Depreciated value at end of 10 years
Ventilating system	$3,950.75	$2,771.83
Glazing, architect's fee, and other items	10,366.87	7,256.46
Painting	760.80	0
Other improvements	185.97	0
Chairs	9,167.24	3,055.75
Booth	5,197.39	0
Draperies	7,075.42	2,358.47
Electric signs and marquee	3,961.36	1,980.63
	$40,674.30	$17,423.14

The Commissioner of Internal Revenue, in accordance with Article 63 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, *infra*, p. 25, included in the lessor's income for the taxable year ending January 31, 1932, one-tenth of their depreciated value, or $1,742.31 (R. 8).

The additional tax paid by the petitioner for 1932 as the result of this addition of $1,742.31 to the income of the Realty Company amounted to $211.61 (R. 8).

Petitioner thereafter filed a timely claim for refund on the ground that the addition of $1,742.31 to the income of the Realty Company was incorrect. This claim was disallowed February 5, 1937 (R. 9).

This suit was brought in the Court of Claims on July 12, 1937 (R. 1).

Upon the foregoing facts the Court of Claims decided that petitioner was not entitled to recover and dismissed the petition (R. 9), holding that the depreciated value of the improvements made by a lessee under the circumstances involved in the instant case is income to the lessor in the year in which such improvements are completed.

SUMMARY OF ARGUMENT

I

It is everywhere acknowledged that the construction of improvements by a lessee under the terms of the lease, where the improvements will outlast the lease's term, constitutes income to the lessor at some time. A divergence of views exists, however, as to the time when the improvements become income. With respect to this there are three different theories:

(a) *The view that the income is realized upon completion of the improvement.*—The legal significance of adding improvements to the lessor's property is precisely equivalent to the payment of advance rentals, and therefore the income is realized when the improvements are complete. The lessor is undoubtedly the owner as soon as the improvements are made, and if title be the test he has then derived income. The cash rentals are allocable in part to the improvements, so that the lessor has the immediate use of the improvement to that extent, just as he has the use and benefit of the rest

of the property. The only reason he is not entirely free to use the property is that he has agreed in advance with the lessee to permit the latter the exclusive use. This circumstance is analogous to the assigned income cases and should not prevent the tax. Moreover, the concept of income does not necessarily require that the respondent have the unrestricted right to enjoy it.

(b) *The view that the income is realized upon the termination of the lease.*—If the restrictions upon enjoyment prevent the income from being treated as derived when the improvements are made, it should follow that the income is received when the restrictions are removed. The principle is well recognized that the release of a liability is the equivalent of receipt, and where income is physically received at a time when there is some restriction upon its use, the time of receipt is deemed to be postponed until the restriction is removed. If that theory is applicable, the income is derived at the expiration or earlier termination of the lease.

(c) *The view that the income is realized upon disposition of the improved property.*—The theory that the income is realized upon the disposition of the property is based upon the view that the increased value which resulted from the improvements is merely appreciation of some character, like an increase resulting from fluctuating conditions. However, there is little similarity between

general conditions causing day-to-day fluctuations and a permanent improvement to the particular realty. Furthermore, this theory is based upon the misconception that there must be an actual physical separation of income from capital. We think the cases show that the concept of income is satisfied where the taxpayer's investment produces new property which, in some form, is made available to him. The simplicity of the theory has appealed to some courts, but if the income is lost as a result of unrelated events occurring between the time of its receipt and the disposition of the property, this theory would permit it to escape taxation altogether. In no other situation is a taxpayer excused from accounting for income because of its subsequent loss.

II

In this case the lease was for a ten-year term and it is agreed that certain of the improvements would outlast the term and that a residual value would remain for the lessor. Accordingly, the Commissioner added one-tenth of the residual value to the income of the lessor for the taxable year. This was in accordance with the Treasury Regulations, which proceed upon the theory that the income is realized when the improvements are complete. The case is squarely within the Regulations and the validity of the tax depends upon the acceptance of the theory which underlies the Regulations.

ARGUMENT

While this case presents the question whether the depreciated value of improvements to leased property, made by a lessee as required by the lease agreement, constitutes income to the lessor in the taxable year, the basic question is whether income is ever realized by the lessor in such cases, and, if so, when. In our memorandum in opposition to the petition it was suggested that the basic question is not presented in satisfactory form here and that a review by this Court might well await a case in which that issue is more clearly presented. We hope that the granting of the writ indicates that the Court is ready to deal with the broad question at this time. Accordingly, we shall not restrict the argument to the particular facts in this case but shall present our views upon the whole problem.

The question first arose under the Revenue Act of 1916. It has recurred from time to time under varying factual situations, but has never before reached this Court and no authoritative decision has been announced. The problem needs clarification and it would be desirable to have a decision which disposes of the basic questions.

I

IMPROVEMENTS MADE BY A LESSEE IN PURSUANCE OF AN AGREEMENT CONSTITUTE INCOME TO THE LESSOR

All of the tribunals which have considered this question have agreed that where the improvements

outlast the lease term the lessor derives income at some time and in some measure from improvements added to his real property by the lessee. However, there has been much diversity of opinion as to when the income is received and how it is to be measured. One line of authorities holds that the income is received when the improvements are made. Another line of cases holds that it is received when the lessor assumes possession of the property, at the end or earlier termination of the lease. A third group of authorities holds that income is not realized until the lessor disposes of the improved property. The first position stated above, adopted in the Treasury regulations and by the court below, we believe to be the correct one. However, we shall deal with these theories in turn and marshal the reasoning and authorities which may be urged in support of each.

(A) THE VIEW THAT INCOME IS REALIZED UPON THE COMPLETION OF THE IMPROVEMENTS

Improvements of the lessor's property, when made by a lessee pursuant to the lease, clearly constitute consideration paid for the use of the premises. Whether or not the cost may be deducted by the lessee (cf. *Duffy* v. *Central R. R.*, 268 U. S. 55), the lessor clearly appears in such cases to have received a consideration in the nature of rent. Improvements made by a lessee are of the same character and quality as a bonus paid by a lessee under an oil and gas lease. It is settled that the bonus is advance royalty. Like treatment of the im-

provements would require them to be classified as advance rentals. *Burnet* v. *Harmel*, 287 U. S. 103. The title to permanent improvements vests at once in the lessor and the value of the property is immediately increased. If title be the test (cf. *Poe* v. *Seaborn*, 282 U. S. 101), the lessor is undoubtedly the owner as soon as the improvements are made, and he has then derived income. Such was the view of the early cases. *Miller* v. *Gearin*, 258 Fed. 225 (C. C. A. 9th), certiorari denied, 250 U. S. 667; *Cryan* v. *Wardell*, 263 Fed. 248 (N. D. Cal.). The Regulations then in effect provided that the depreciated value of improvements erected by a lessee constituted taxable income to the lessor upon the termination of the lease.[1] But the cited cases overruled the existing regulations, whereupon the Treasury made changes to conform to the decisions.[2]

Against this view it may be urged that the lessor has not "derived" the income because he is not free to use it. But the lessor derives rent from the improvements and, to that extent at least, it would appear that he does use the improved property.

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[1] Article 4, par. 50, Regulations 33 (Revised Ed.); Article 48, Regulations 45.

[2] T. D. 3062, 3 Cumulative Bulletin 109; Mim. 2714, 4 Cumulative Bulletin 90; Article 48, Regulations 45 (1920 Ed.). The Regulations under the later Acts have consistently regarded the income as realized upon the completion of the improvements. The Regulations under the 1921 and subsequent Acts have permitted the gain to be spread over the life of the lease. Article 48, Regulations 62, 65, and 69; Article 63, Regulations 74 and 77; Article 22 (a)-13, Regulations 86 and 94.

The only reason he is not entirely free to use it is that he has agreed in advance that the lessee may have the exclusive right to use it for the term of the lease. In other situations it has been held that such an assignment does not avoid the tax. *Lucas* v. *Earl*, 281 U. S. 111; *Lonsdale* v. *Commissioner*, 32 F. (2d) 537 (C. C. A. 8th), certiorari denied, 280 U. S. 575. Cf. *Burnet* v. *Wells*, 289 U. S. 670.

Moreover, the concept of income does not necessarily require that the recipient have the exclusive right to enjoy it. The wife in a community property State clearly does not have any such exclusive enjoyment, but it is nevertheless settled that she is the recipient of one-half of her husband's income merely because under local law she is the owner of one-half. *Poe* v. *Seaborn*, *supra*. Analogous decisions indicate that income does not lose its character as such because prior to receipt it was dedicated to a particular use. *Cleveland Ry. Co.* v. *Lucas*, 36 F. (2d) 347 (C. C. A. 6th), certiorari denied, 281 U. S. 743. The constructive receipt cases also involve situations where the recipient has no opportunity to devote the income at will to any purpose desired. Thus the employee who receives income because his employer pays his tax is not free to devote such income to any purpose he desires. It can be used only to pay his tax. Nevertheless it is income. *Old Colony Tr. Co.* v. *Commissioner*, 279 U. S. 716. Likewise, the corporation which receives income when another cor-

poration pays its liabilities is not free to devote such income to any desired purpose. *United States* v. *Hendler*, 303 U. S. 564. See, also, *United States* v. *Boston & M. R. Co.*, 279 U. S. 732.

Since the tax is not computed upon the *value* of the improvements at the time they are made, it would appear that sufficient allowance has been made under this rule for the lessee's exclusive use during the term of the lease.

If this theory is sound, the decision below should be affirmed.

(B) THE VIEW THAT INCOME IS REALIZED UPON THE TERMINATION OF THE LEASE

Since improvements are usually made for the primary purpose of adapting the premises to the lessee's business requirements, it may be said that any benefit derived by the lessor at the time of construction is incidental. Cf. *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376, where it was held that a corporation which had the right to buy the oil produced at a price deemed to be favorable was conducting the operations for its own benefit. Furthermore, the lessee has the exclusive right to use the property during the term of the lease and the lessor's use is thus restricted. These circumstances have been relied upon to support the view that the income is not realized by the lessor until he actually comes into possession either at the expiration of the lease or upon its earlier termination.

This was the original view of the Treasury Department and the earliest Regulations were promulgated upon this theory.[8]

Further support for this view may be drawn from the cases which treat the release of a liability as the equivalent of receipt. *United States* v. *Kirby Lumber Co.*, 284 U. S. 1; *Helvering* v. *Amer. Chicle Co.*, 291 U. S. 426; and *Maryland Casualty Co.* v. *United States*, 251 U. S. 342. Those cases indicate that where income is physically received at a time when there is some restriction upon its use, the time of receipt is deemed to be postponed until the restriction is removed. The absence of restriction as to its disposition was one of the elements which this Court mentioned in *North American Oil* v. *Burnet*, 286 U. S. 417, 424, although it may make a difference whether the restriction is forced upon the taxpayer (cf. *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481) or is one which he assumes voluntarily.

If this be the correct theory, the entire gain can be taxed in a single subsequent year, when the lease terminates, instead of being prorated over the life of the lease.

(C) THE VIEW THAT INCOME IS REALIZED UPON THE DISPOSITION OF THE IMPROVED PROPERTY

The conclusion that the income is realized upon the disposition of the property was first announced

[8] See note 1, p. 11.

in 1935. *Hewitt Realty Co.* v. *Commissioner,* 76 F. (2d) 880 (C. C. A. 2d). It is based upon the theory that the increased value which results from improvements made to a particular property is merely appreciation of the same character as an increase in value resulting from the growth of the surrounding neighborhood or the increase in value of a share of stock. This was the prevailing view in the *Hewitt* case, Judge Chase dissenting.

This conclusion is predicated largely upon an interpretation of *Eisner* v. *Macomber,* 252 U. S. 189, as meaning that there must be an actual separation of income from capital. We think that this is too narrow a view. Subsequent to *Eisner* v. *Macomber,* this Court has held in *Marr* v. *United States,* 268 U. S. 536, 540, "that the gain in value resulting from profits is taxable as income, not only when it is represented by an interest in a different business enterprise or property, but also when it is represented by an essentially different interest in the same business enterprise or property." See also *Helvering* v. *Midland Ins. Co.,* 300 U. S. 216, 225. Thus in *Koshland* v. *Helvering,* 298 U. S. 441, the distribution of a different class of stock in the same enterprise supplied the "derivation" which was found wanting in *Eisner* v. *Macomber.* In each case the corporate funds continued to be held by the corporation so that it is apparent that an actual physical separation from capital need not be shown to establish the necessary "derivation." All that is necessary is that

the taxpayer's investment produce new property which in some form is made available to him.

The statement (p. 884) in the *Hewitt* opinion, that this theory "answers every fiscal necessity far more directly and simply than any other formula," is inaccurate. Under this theory no income whatever is deemed to flow from the lessee to the lessor; whether the lessor realizes income depends upon the price he gets from a purchaser instead of upon the value of the thing he receives from the lessee. Where the sale occurs some time after the lessor has come into possession of the improved property the selling price will be affected by later events which may have caused the increased value to disappear, leaving no profit whatever. Accordingly, the adoption of this theory will permit income from improvements to escape taxation entirely in many cases because of supervening factors wholly unrelated to the improvements. In other situations the loss of income after its receipt does not excuse the taxpayer from accounting for it. Therefore, whatever is to be said for the simplicity of this theory it clearly does not answer every fiscal necessity. Like the others, it must be judged upon its merits alone.

The *Hewitt* case involved other factors not present here and the opinion is at least partially based upon the fact that the lessee had an option to renew. The Court of Claims distinguished this case upon that ground.

If this theory must be applied, the tax should await the disposition of the property and will depend upon the selling price, except with respect to the portable improvements.[a]

II

THIS CASE IS SQUARELY WITHIN THE TREASURY REGULATIONS

In the instant case the lessor as a subsidiary corporation of the petitioner leased property to be used as a moving picture theatre. The lease was for a term of ten years and provided that the lessor should make certain alterations to the property and that the lessee should paint, decorate, and install the latest type of moving picture and talking apparatus, theatre seats, and furniture. It is agreed that certain of the improvements would last beyond the ten-year term, and there is no dispute as to the residual value. In this situation the Commissioner added one-tenth of the agreed residual value to the income of the lessor for the taxable year. This was in accordance with Article 63, Regulations 77 (Appendix, *infra*, p. 25), which proceeds on the theory that the lessor realizes the income when the improvements are complete. As shown above, this theory is consistent with the decision in *Miller* v. *Gearin*, 258 Fed. 225, *supra*, p. 11, and was adopted by the Treasury following the denial of certiorari in that case.

During the period from 1920 to 1935 the decisions in *Miller* v. *Gearin* and *Cryan* v. *Wardell*,

[a] See *infra*, p. 20.

supra, were recognized as authority for the proposition that the improvements were taxable income upon their completion. They were so recognized by the Circuit Court of Appeals for the First Circuit in *United States* v. *Boston & Providence R. R. Corp.,* 37 F. (2d) 670, and *Crane* v. *Commissioner,* 68 F. (2d) 640; by the United States District Court for the Western District of Kentucky in the case of *Kentucky Block Coal Co.* v. *Lucas,* 4 F. Supp. 266; and by the Board of Tax Appeals in *Scott* v. *Commissioner,* 9 B. T. A. 1219, *Alexander* v. *Commissioner,* 13 B. T. A. 1169, and *Martin* v. *Commissioner,* 24 B. T. A. 813. In the decision by the District Court in *Kentucky Block Coal Co.* v. *Lucas, supra,* and in these three Board of Tax Appeals cases the question was the same as the one in issue here. They all held that the depreciated value of improvements erected by a lessee constituted income to the lessor at the time of their erection.

Since the decision of the Circuit Court of Appeals for the Second Circuit in *Hewitt Realty Co.* v. *Commissioner, supra,* in 1935, a number of District Court decisions have followed that case. These decisions are as follows: *Staples* v. *United States,* 21 F. Supp. 737 (E. D. Pa.); *Hilgenberg* v. *United States,* 21 F. Supp. 453 (Md.); *English* v. *Bitgood,* 21 F. Supp. 641 (Conn.); *Everett Dominick* v. *United States* (S. D. N. Y.), decided June 30, 1938, not yet officially reported but found in 1938 C. C. H., Vol. 4, p. 10300; *Lamont Dominick* v. *United States* (S. D. N. Y.), decided July 21,

1938, not yet officially reported but found in 1938 C. C. H., Vol. 4, p. 10406; *Fifteenth Street Inv. Co. v. Nicholas*, 23 F. Supp. 863 (Col.). On the other hand, the Board of Tax Appeals [4] and the United States District Court for the Territory of Hawaii [5] have declined to follow the decision in the *Hewitt Realty Co.* case and have reached the conclusion that the value of improvements erected under such circumstances constitutes taxable income to the lessor at the time of their erection.

Petitioner's contention that the lessee was not required to spend any amount whatever for the benefit of the lessor and that his expenditures might well have been limited to improvements which would have had a life not exceeding the term of the lease is not well taken. The lessee agreed to install "equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord" (R. 7). The lessee could not have fulfilled this obligation by installing flimsy equipment of an unsubstantial character. In all likelihood, had this been done, the lessor would have been the first to object. In fact it clearly was not contemplated

[4] *Morphy* v. *Commissioner*, 35 B. T. A. 289; *Sloan* v. *Commissioner*, 36 B. T. A. 370.

[5] *Campbell* v. *United States* (T. H.), decided June 21, 1938, not yet officially reported but found in 1938 C. C. H., Vol. 4, p. 10283.

and was not done. Moreover, the installation of inferior material would have defeated the lessee's own purpose to attract the public to its theatre. Judge Chase's dissenting opinion in the *Hewitt Realty Co.* case, *supra*, reasons that the character of what the lessor receives remains the same even though the lessee is not obligated to make the improvements. Here the petitioner was clearly required to make improvements which would be substantial and leave a residual value for the lessor and actually made such improvements. The improvements are listed in the statement of facts. Some of them clearly would be classed as portable and thus satisfy the requirements of income even if the prevailing *Hewitt Realty Co.* opinion is applicable.

Petitioner's suggestion that the lessee made a gift of the improvements is unsound and the cases dealing with business subsidies (Br. 17) are clearly distinguishable because here the improvements were obviously not made without consideration. Unlike this case, no landlord-tenant relationship or any other contractual relationship existed in the cited cases. We submit that no payment directly attributable to such a relationship could be a gift or subsidy. The latter distinction applies also to the cases cited (Br. 19) dealing with bargain purchases by employees. Unless the intention to pay additional compensation appears, the transaction is not necessarily connected with an employer-employee rela-

tionship, but where it does appear that the difference in value is intended to compensate for services, that difference is clearly income because it is due wholly to the employer-employee relationship. Cf. *Bogardus* v. *Commissioner*, 302 U. S. 34, 41.

CONCLUSION

The value of improvements erected by a lessee upon leased land constituted income to the lessor. The soundest theory seems to be that such income is taxable at the time the improvements are erected.

The decision of the court below is correct and should be sustained.

Respectfully submitted.

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November 1938.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after the date of the enactment of this Act, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

* * * * *

Treasury Regulations 33, promulgated under the Revenue Acts of 1916 and 1917:

ART. 4. * * * *Permanent improvements under lease or rental contracts.*—When improvements become a part of real estate, the difference between cost of the improvements and allowable depreciation dur-

ing the lease term is gain or profit to the lessor at the end of the lease term and is to be accounted for as income at that time. (T. D. 2442.)

Treasury Regulations 45, promulgated under the Revenue Act of 1918 (1920 Ed.):

ART. 48. *Improvements by lessees.*—When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements. If, for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same completed became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease the lessor is entitled to deduct as a loss of

the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, or the value thereof subject to the lease on March 1, 1913, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance. See articles 109 and 164.

Treasury Regulations 62, promulgated under the Revenue Act of 1921 (1922 Ed.):

ART. 48. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the termination of the lease and report as income for each year of the lease an aliquot part thereof.

If for any other reason than a bona fide purchase from the lessee by the lessor the lease is terminated, so that the lessor comes into possession or control of the property

prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on the cost or the value subject to the lease as of that date, whichever is lower, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. See articles 109 and 164.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 63. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

Except in cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives no income by reason thereof, and, just as when the lessor comes into possession or control of the property upon the expiration of the lease, the basis for determining gain or loss to the lessor from the subsequent sale or other disposition of the buildings or improvements and for depreciation in respect of such property is the amount previously reported as income by the lessor because of the erection of the buildings or improvements, except that if the buildings or improvements were acquired prior to March 1, 1913, the basis shall be their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or

improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. (See articles 130 and 204.)

In all cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise.

Treasury Decision 3062, 3 Cumulative Bulletin 109:

SECTION 213 (a), ARTICLE 48: Rents and royalties. 37–20–1198 T. D. 3062

INCOME TO LESSORS OF IMPROVEMENTS MADE UPON REAL ESTATE BY LESSEES—ARTICLES 48, 109, AND 164 OF REGULATIONS 45, AMENDED

Articles 48, 109, and 164 of Regulations 45 are hereby amended to read as follows:

ART. 48. *Rents and royalties.*—When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements. If, for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same com-

pleted became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease the lessor is entitled to deduct as a loss of the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, or the value thereof subject to the lease on March 1, 1913, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance. (See articles 109, 164.)

* * * * *

Mimeographed Decision 2714, 4 Cumulative Bulletin 90:

SECTION 213 (a), ARTICLE 48: Improvements by lessees. 8-21-1474
Mim. 2714

(Also Section 214 (a) 1, Article 109.)
(Also Section 214 (a) 8, Article 164.)

INCOME TO LESSOR FROM IMPROVEMENTS ERECTED BY THE LESSEE UPON LEASED GROUND

Treasury Decision 3062 (C. B. 3, pp. 109, 144, 171), dated September 1, 1920, dealing with the question of the realization of income by a lessor from the erection by the lessee of improvements on leased ground, has been the subject of many inquiries. It is deemed advisable, therefore, to state the reasons for its promulgation and to demonstrate the proper construction of it by application to a specific case.

On February 6, 1917, by Treasury Decision 2442 (not in bulletin service), the Bureau held that where, under the terms of a rental or lease contract, a tenant agrees to erect a building or other permanent improvement upon the freehold of another, the building or improvements become a part of the realty, and the difference between the cost of the improvements and the allowable depreciation during the lease term is gain or profit to the lessor at the end of the lease term and is to be accounted for as income at that time.

The ruling contained in Treasury Decision 2442 was adhered to by the Bureau and was embodied, with some minor changes, in Regulations 33, revised, article 4, paragraph 50, and in Regulations 45, article 48. The Bureau abandoned this ruling only when forced to do so by the courts. In the case of *Miller* v. *Gearin*, 258 Fed. 225, the Circuit Court of Appeals for the Ninth Circuit held that the value of improvements erected upon leased ground by a lessee is not income to the lessor *at the expiration of the term of the lease.* A writ of certiorari was sought from the Supreme Court but was denied. Following this decision came the case of *Cryan* v. *Wardell*, 263 Fed. 248, reaching the same conclusion. In both of these decisions it is held that the value of improvements erected on leased ground by a lessee is not income of the lessor at the termination of the period of the lease, and it is stated, obiter dictum, that the income, if any, is realized when the buildings or improvements are erected and title passes to the lessor. In *Miller* v. *Gearin, supra,* the court said:

"The lessor acquired nothing in 1916 (the year of the termination of the lease) save the possession of that which for many years

had been her own. It was not a gain but a loss. Assuming that the building was income derived from the use of the property we think it clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value."

And in *Cryan* v. *Wardell*, supra, it is stated:

"The right to levy the tax turns upon the question: When did title to this building vest in plaintiff and become a part of her property for the purpose of taxation? I am of opinion that under well-settled principles, aptly expressed in section 1013, Civil Code of California, the moment the building was erected, which the terms of the lease show was to become and remain an integral portion of the land upon which it was constructed, the title thereto vested as completely in plaintiff as though constructed by the plaintiff herself, * * *. It, therefore, became, upon the completion, a part and parcel of plaintiff's income-bearing property, and was subject to taxation in her as of that date."

As a result of these decisions, the office modified its prior rulings on the subject, and T. D. 3062 was accordingly promulgated.

The adoption in T. D. 3062 of the view occasioned by the above cited decisions, that the value of improvements erected on leased ground by the lessee is income to the lessor upon the passage of title, raised the further question as to the measure of the income to be returned by the lessor.

Although the lessor has acquired title to the improvements upon their erection by the lessee, yet it is obvious that the lessor has not received their full value, as measured by

an unrestricted dominion over them, inasmuch as his proprietorship is subject to the exclusive right of the lessee to their possession and use during the term of the lease. In recognition of this point it is held in T. D. 3062, that the lessor must include in gross income for the year in which title passes the depreciated value of the improvements—that is, he includes in gross income the estimated present value to him of the improvements, the possession and enjoyment of which is postponed until the termination of the period of the lease. To compute this depreciated value, the value of the land free from the lease without the improvements is subtracted from the value of the land subject to the lease and with the improvements. Inasmuch as the lessor has included in income only the depreciated value of the improvements, in effect taking his depreciation deductions in advance, he is entitled to no depreciation deduction with respect to such improvements until the expiration of the term of the lease when he gains the possession.

The following example is given to illustrate the proper construction to be given to T. D. 3062:

A, in 1915, leases certain land to B for 20 years. B agrees, in part consideration for the lease, to erect on the leased ground a building, specifications agreed upon, of an estimated life of 25 years and to cost $50,000, which building is not to be subject to removal by B. The building is completed in 1920.

A realizes income in 1920, the year in which title to the building passes. The measure of the income is the present value to A of the building, of an estimated life of 25

years and cost of $50,000, the use and enjoyment of which is postponed for 15 years. The depreciated value of the building at the termination of the period of the lease will be approximately $20,000—that is, cost less depreciation sustained. The income of A, then, is the discounted value of $20,000 receivable at the end of 15 years. If market value reflects intrinsic value, this amount should equal the difference between the value of the land free from the lease without the buildings and the value of the land subject to the lease with the building. However, any other evidence available should be considered in determining this present worth to the taxpayer of the legal title to the encumbered building. Since A has included in income only the depreciated value of the building, he is entitled to a depreciation deduction with respect to such building only for the years after the termination of the period of the lease when A has come into possession. This depreciation deduction to which A is entitled for 1935 and subsequent years should be computed on a basis of the estimated remaining life of the building and a "cost" value equal to the market value placed on the encumbered building by A in the year of its erection, i. e., the annual depreciation deduction for 1935 and subsequent years will be the quotient obtained by dividing (a) the value of the improvements to A as determined by him when the same completed became part of the realty, by (b) the number of years in the estimated remaining life of the improvements from the termination of the lease.

In any case in which the term of the lease is greater than the estimated life of the improvement no income should be accounted

for by the lessor at the time of the passage of title. Also if the improvements will have no value at the termination of the lease, as is often the case in mining leases, no income is realized by the lessor.

U. S. GOVERNMENT PRINTING OFFICE: 1938

SUPREME COURT OF THE UNITED STATES.

No. 98.—October Term, 1938.

M. E. Blatt Company, Petitioner, vs. United States. } On Writ of Certiorari to the Court of Claims.

[December 5, 1938.]

Mr. Justice Butler delivered the opinion of the Court.

Petitioner paid, and in this suit seeks to recover, an amount included in a deficiency assessment made by the Commissioner of Internal Revenue as additional income tax for the year ending January 31, 1932. The question is whether petitioner is liable under Revenue Act of 1932, § 22(a).[1]

The material substance of the findings follows.

For itself and a subsidiary corporation, petitioner made consolidated return. The commissioner added to the income of the subsidiary on account of improvements made to its property by a lessee. He ruled the improvements were income to lessor in that year to the extent of their value at termination of the lease.

Lessor purchased the real estate in 1927, and September 13, 1930, leased it for use as a moving picture theater for a term of ten years, beginning upon completion of improvements to be made. At its own cost and expense, lessor agreed to make alterations in accordance with plans and specifications prepared by an architect selected by the parties. Lessee agreed to install the latest type of moving picture and talking apparatus, theater seats and all other fixtures, furniture and equipment necessary for the successful operation of a modern theater to become the property of lessor at the expiration or sooner termination of the lease.

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[1] "'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . ." 47 Stat. 178. The regulation applied by the commissioner (Reg. 77, Art. 63) has since been changed. See Reg. 94 and 86, Art. 22(a)-13.

Lessor made a contract with the builder to make the contemplated improvements and agreed to pay, up to a specified limit, actual cost, plus builder's profit and architect's fee. Additional work ordered by lessee was to be paid for by it. Lessee consented to the terms of the contract and agreed to pay for work and materials ordered by it. All improvements were completed in January 1931; lessee took possession of the property February 1 of that year.

The total cost of all improvements was $114,468.77; lessor paid $73,794.47; lessee paid the balance, $40,674.30. "The estimated depreciated value at the termination of the lease of the alterations and improvements paid for by the lessee was computed by the commissioner and was agreed to by the plaintiff [petitioner], as follows:

	Cost	Depreciated value at end of 10 years
[1] Ventilating system	$3,959.75	$2,771.83
[2] Glazing, architect's fee and other items	10,366.37	7,256.46
[3] Painting	760.80	0
[4] Other improvements	185.97	0
[5] Chairs	9,167.24	3,055.75
[6] Booth	5,197.39	0
[7] Draperies	7,075.42	2,358.47
[8] Elec. signs and marquee	3,961.36	1,980.63
TOTAL	$40,674.30	$17,423.14"

From these figures it appears that the calculations were based on annual depreciation of items [1] and [2] at 3 per cent., on [5] and [7], at 6⅔ per cent., on [8], at 5 per cent., and on [3], [4], and [6], at 10 per cent."

For the year in question, the commissioner added to income of lessor $1,742.31, one-tenth of the cost so depreciated. The resulting additional tax was $211.61. Petitioner paid it; the commissioner disallowed claim for refund. The lower court held petitioner not entitled to recover; it sustained the tax on the ground that, immediately upon completion of the improvements made by lessee, they became the property of lessor, and constituted compensation paid by lessee as additional rental for the use of the leased premises.

Petitioner insists that where improvements are made by lessee, there is no realization of gain at the time the improvements are

mpleted; that the accession of value to the property is not income d a capital addition. The United States says that, while the se presents the question whether depreciated value of improve-ents by lessee constitutes income to lessor in the taxable year, e "basic question is whether income is ever realized by the lessor such cases, and if so, when." Assuming that improvements ade by lessee and which will outlast the term constitute income lessor at some time, its brief discusses the questions whether e income is realized upon (1) completion of the improvements, 2) termination of the lease, or (3) disposition of the improved roperty. It concludes that the "soundest theory seems to be that ch income is taxable at the time the improvements are erected." And, without supporting the lower court's ruling that the esti-mated depreciated value at the end of the ten-year term consti-tuted additional rent or compensation paid for the use of the premises, it asks that the judgment be upheld.

We are not called on to decide whether under any lease or in any circumstances, income is received by lessor by reason of im-provements made by lessee, nor to choose, for general approval or condemnation, any of the theories expounded by the United States. Concretely, the question presented is whether, under the lease here involved, one-tenth of what the commissioner and taxpayer call and agree to be "estimated depreciated value," as of the end of the term, was income to petitioner in the first year of the term. And that question is to be decided upon the lower court's special find-ings unaffected by any statement of fact, reasoning, or conclusion that may be found in its opinion.[2]

There is nothing in the findings to suggest that cost of any improvement made by lessee was rent or an expenditure not prop-erly to be attributed to its capital or maintenance account as dis-tinguished from operating expense. While the lease required it to make improvements necessary for successful operation, no item was specified, nor the time or amount of any expenditure. The re-quirement was one making for success of the business to be done on the leased premises. It well may have been deemed by lessor essential or appropriate to secure payment of the rent stipulated in the lease. Even when required, improvements by lessee will

[2] Stone v. United States, 164 U. S. 380, 383. Crocker v. United States, 240 U. S. 74, 78. Brothers v. United States, 250 U. S. 88, 93. United States v. Wells, 283 U. S. 102, 120. United States v. Esnault-Pelterie, 299 U. S. 201, 206. And see American Propeller Co. v. United States, 300 U. S. 475, 479-480.

not be deemed rent unless intention that they shall be is plainly disclosed. Rent is "a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property . . . ; . . . it does not include payments, uncertain both as to amount and time, made for the cost of improvements . . . ."[3] The facts found are clearly not sufficient to sustain the lower court's holding to the effect that the making of improvements by lessee was payment of rent.

It remains to be considered whether the amount in question represented taxable income, other than rent, in the first year of the term.

The findings fail to disclose any basis of value on which to lay an income tax or the time of realization of taxable gain, if any there was. The figures made by the commissioner are not defined. The findings do not show whether they are intended to represent value of improvements if removed or the amount attributable to them as a part of the building.

The figures themselves repel the suggestion that they were intended to represent amounts obtainable for the items if removed. We are not required to assume that the commissioner intended his estimates to represent salvage, at the end of the term, of ventilating system, glazing, architect's fees and the like, draperies, chairs, electric signs, and marquee, the useful lives of which in place have declined from 30 to 66⅔ per cent. It does not appear that if detached from the building they would then have any value, even as junk, over necessary cost of removal. It is clear that, if any value as of that time may be attributed to them, it is included in and not separable from that of the leased premises.

Equally conjectural would be assumption that the figures represent enhancement of value of the leased premises by reason of the improvements when new or as deteriorated at the end of the term. The leased property is capable of inventory and analysis for the purpose of ascertaining original and estimated present costs of its elements and other relevant facts as indications of worth to be taken into account in determining its value; i.e., the money equivalent of the property as a whole.[4] But present or

[3] Duffy *v.* Central R. R., 268 U. S. 55, 63. Dodge *v.* Hogan, 19 R. I. 4, 11. Guild *v.* Sampson, 232 Mass. 509, 513. Garner *v.* Hannah, 6 Duer 262, 266. Board of Comm'rs of Caddo Levee Dist. *v.* Pure Oil Co., 167 La. 801, 811. 2 Blackstone, p. 41.

[4] West *v.* C. & P. Tel. Co., 295 U. S. 662, 671. Olson *v.* United States, 292 U. S. 246, 255. Standard Oil Co. *v.* So. Pacific Co., 268 U. S. 146, 155.

ue value, however ascertained, is single in substance; it can-
be arrived at by mere summation of actual or estimated cost
nstituent elements, new or depreciated.[5] The addition to
e of the leased premises resulting from the lessee's improve-
nts may not be arrived at by formula or arithmetically by merely
ting against each item or element its cost less depreciation esti-
ted to accrue during the term of the lease.[6] The amount in-
ded in the total value of the structure reasonably to be attributed
the improvements after use for ten years is not ascertainable by
e simple calculations employed by the commissioner.

Granting that the improvements increased the value of the build-
g, that enhancement is not realized income of lessor.[7] So far as
cerns taxable income, the value of the improvements is not dis-
guishable from excess, if any there may be, of value over cost
f improvements made by lessor. Each was an addition to capital;
t income within the meaning of the statute.[8] Treasury Regula-
ns can add nothing to income as defined by Congress.[9]

But, assuming that at some time value of the improvements would
e income of lessor, it cannot be reasonably assigned to the year
n which they were installed. The commissioner found that at the
nd of the term some would be worthless and excluded them. He
lso excluded depreciation of other items. These exclusions imply
hat elements which will not outlast lessee's right to use are not
t any time income of lessor. The inclusion of the remaining value
s to hold that petitioner's right to have them as a part of the
uilding at expiration of lease constitutes income in the first year
f the term in an amount equal to their estimated value at the end
f the term without any deduction to obtain present worth as of date
f installation. It may be assumed that, subject to the lease, lessor

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[5] Denver Stock Yard Co. v. United States, 304 U. S. 470, 479.

[6] Minnesota Rate Cases, 230 U. S. 352, 434. Bluefield Co. v. Pub. Serv.
Comm., 262 U. S. 679, 690. Standard Oil Co. v. So. Pacific Co., 268 U. S. 146,
57, 159. McCardle v. Indianapolis Co., 272 U. S. 400, 416.

[7] Hewitt Realty Co. v. Commissioner (CCA 2), 76 F. 2d 880, 884. Eisner v.
Macomber, 252 U. S. 189, 207. Lucas v. Alexander, 279 U. S. 573, 577. Cf.
Bowers v. Kerbaugh-Empire Co., 271 U. S. 170, 175.

[8] United States v. Phellis, 257 U. S. 156, 169, 175. Merchants' L. & T.
Co. v. Smietanka, 255 U. S. 509, 519-520. Taft v. Bowers, 278 U. S. 470, 480,
et seq. Lucas v. American Code Co., 280 U. S. 445, 449. Eckert v. Burnet,
283 U. S. 138, 142. Burnet v. Logan, 283 U. S. 404, 412-413. United States v.
Safety Car Heating Co., 297 U. S. 88, 99. Koshland v. Helvering, 298 U. S.
441, 444-445. Cf. Commissioner v. Van Vorst (CCA 9), 59 F. 2d 677, 680.

[9] Koshland v. Helvering, 298 U. S. 441, 447.

became owner of the improvements at the time they were made. But it had no right to use or dispose of them during the term. Mere acquisition of that sort did not amount to contemporaneous realization of gain within the meaning of the statute.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

PREME COURT OF THE UNITED STATES.

No. 98.—October Term, 1938.

E. Blatt Company, Petitioner, *vs.* United States. } On Writ of Certiorari to the Court of Claims.

[December 5, 1938.]

Mr. Justice Stone.

acquiesce in that part of the Court's opinion which construes findings below as failing to establish that the lessees' improvets resulted in an increase in market value of the lessor's land he taxable year. As it is unnecessary to decide whether such ease, if established, would constitute taxable income of the or, I do not join in so much of the opinion as, upon an asption contrary to the findings, undertakes to discuss that stion.